



**Central
Intelligence**

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Japan: Forces for Economic Change

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National Intelligence Estimate

~~**Confidential**~~

*NIE 41-2-88
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The Central Intelligence Agency, the Defense Intelligence Agency, the National Security Agency, and the intelligence organizations of the Departments of State and the Treasury.

Also Participating:

The Deputy Chief of Staff for Intelligence, Department of the Army

The Director of Naval Intelligence, Department of the Navy

The Assistant Chief of Staff, Intelligence, Department of the Air Force

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JAPAN: FORCES FOR
ECONOMIC CHANGE

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Information available as of 28 April 1988 was used in the preparation of this Estimate, which was approved by the National Foreign Intelligence Board on that date.

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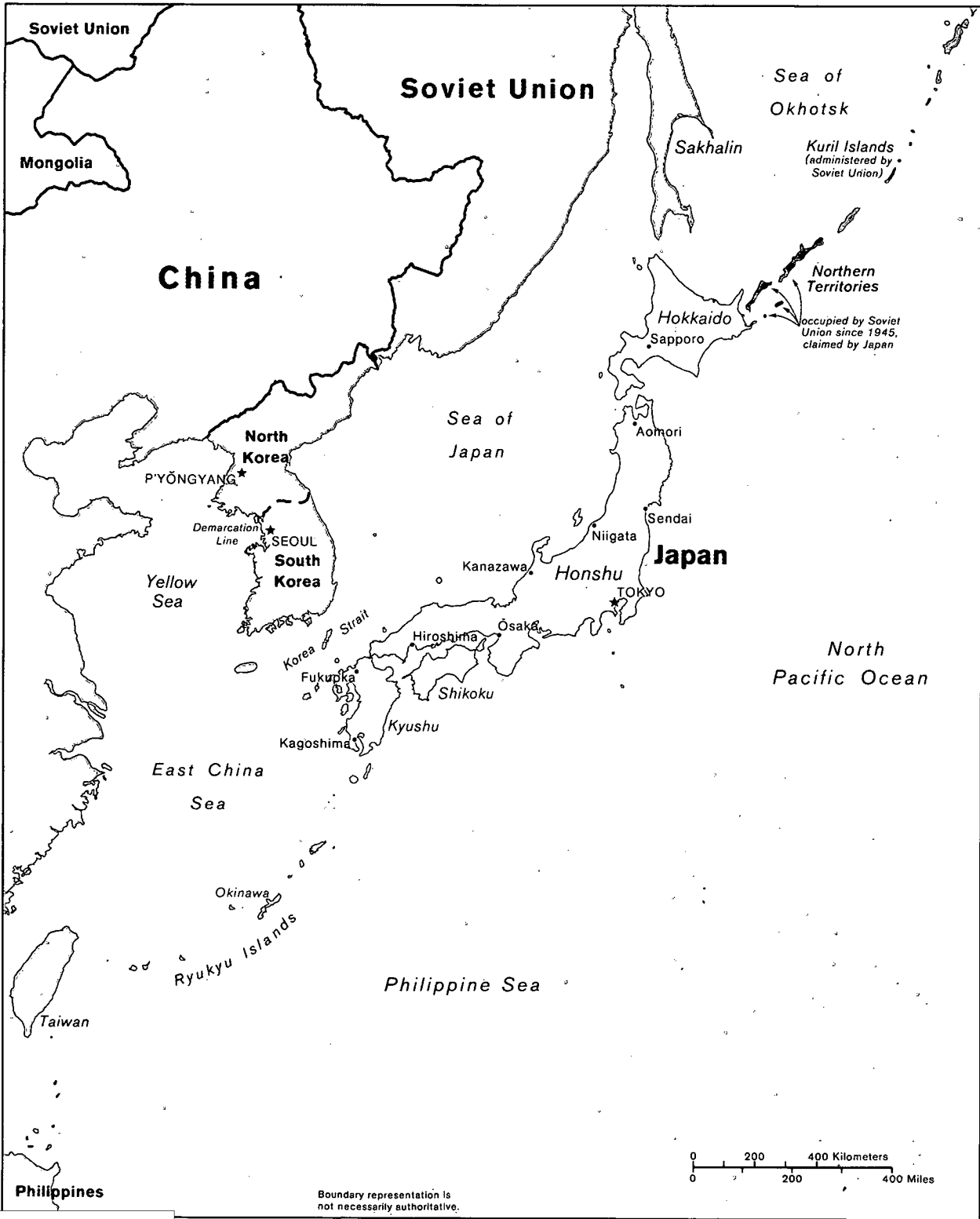
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KEY JUDGMENTS

Japan's export boom is over; the country will depend increasingly on domestic demand to keep the economy growing. The enormous appreciation of the yen is forcing Japan's private sector to significantly alter its business practices both at home and abroad. Economic rivals, particularly in East Asia, are making inroads into some of Japan's domestic and foreign markets. Japanese foreign investment is soaring and will continue to grow rapidly—although at a reduced rate—both in East Asia and in the United States over the next five years. Lower-cost foreign goods will begin to chip away at the ability of Japan's distribution system to favor products produced at home. []

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The Japanese Government will make incremental changes in taxes and import policies to accommodate these trends. Land reform is also being considered, in part as a means of stimulating housing demand and creating a larger market for capital and consumer goods. Over time, these changes will be important to restructuring the economy and shifting the focus from rewarding saving to encouraging consumption. The effect on the Japanese economy of the incremental changes that we expect will be very gradual. []

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The pace of the changes will be conditioned in part by economic events. So far Japan's economy is performing satisfactorily despite the appreciation of the yen. We believe the government would use some fiscal stimulus to offset a temporary slowdown. A global recession, which would significantly reduce growth in Japan, would pose a risk to the ability of the government to make domestic reforms and to liberalize trade, however. A recession would lead to greater declines in exports, reduce domestic income, and restrain domestic spending, thus limiting the government's room to introduce new policies. A major decline in the yen would hinder the slow restructuring process by taking pressure off the government and the private sector to make changes. []

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Japan's trade surplus will continue to decline as long as Japanese domestic growth and the yen remain strong. This trend will reduce, but not eliminate, trade friction with the United States. Japan will be as tough as ever in each negotiation on every specific trade issue. It will dismantle formal and informal trade barriers only very slowly, even under intense pressure. []

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Although Japan does not actively seek to translate its economic power into increased international influence, it will be drawn increasingly into broad issues related to the political and economic stability of

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countries that host Japanese investments, including much of Asia. Japanese companies abroad will become enmeshed in host-country domestic issues, such as taxation and general business policy. While increased Japanese presence overseas will put new competitive pressures on US corporations and other multinationals, the internationalization of Japan's industry also will create opportunities for cooperation with the United States on some issues. 

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Japan will remain firmly attached to its alliance with the United States and retain its strong identification with the West. However, should the USSR launch a major political and economic initiative toward Japan, including discussions on the Northern Territories, we believe Japan would respond favorably. For example, the Japanese Government may well encourage private firms to increase economic interchanges with the Soviets. We believe a Soviet initiative is likely within the five-year time frame of this Estimate. 

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DISCUSSION

1. Japan is at a watershed in its economic development. The public policies and practices of the three decades of the postwar period, which led to rapid export growth and periodic surges in the current account surplus, seem increasingly unsuited to the economic environment of the late 1980s and beyond. It will be increasingly difficult for Japan to use an export surge as an outlet for surplus industrial output because the appreciation of the yen has reduced the competitive edge for Japan's exports.

Postwar Growth Formula

In the 1950s and 1960s, Japan adopted policies geared to rapid economic growth:

- The government sector was kept relatively small, which allowed low average tax rates.
- Infrastructure spending focused on business rather than on public welfare.
- Private savings were encouraged, while consumption was discouraged.

Much of the new capital was aimed at producing for foreign markets.

Both economic growth and industrial investment slowed in the 1970s. A fourfold increase in energy prices shocked the economy. The gains from the process of assimilating foreign technologies began to slow. In response, economic policy changed significantly. Budget surpluses were replaced by prodigious deficits, which reached 5.5 percent of GNP in 1978.

Concerned over the huge deficits of the late 1970s, the government turned in the 1980s to a tight fiscal policy. Including the budgets of local governments, the governmental deficit fell from a peak of 5.5 percent of GNP in 1978 to near balance in 1986. This fiscal tightening contributed importantly to the trade surplus.

The Burgeoning Foreign Surplus

2. The most obvious feature of Japan's changing economic scene in the 1980s is the growth of a tremen-

dous surplus in foreign trade in goods and services—the current account. (See figure 1.) This growth is based on both foreign and domestic elements:

- The US economy, Japan's biggest customer by far, grew rapidly as it recovered from the 1982 recession, fueling demand for Japanese goods.
- At the same time, Japanese domestic growth slowed to half its 1970s pace, reducing the growth of demand for imports.
- The yen/dollar exchange rate reached such heights in the mid-1980s that most Japanese products became very competitive, fueling enormous foreign demand and providing profits for further Japanese expansion of output resulting in increased global market share.

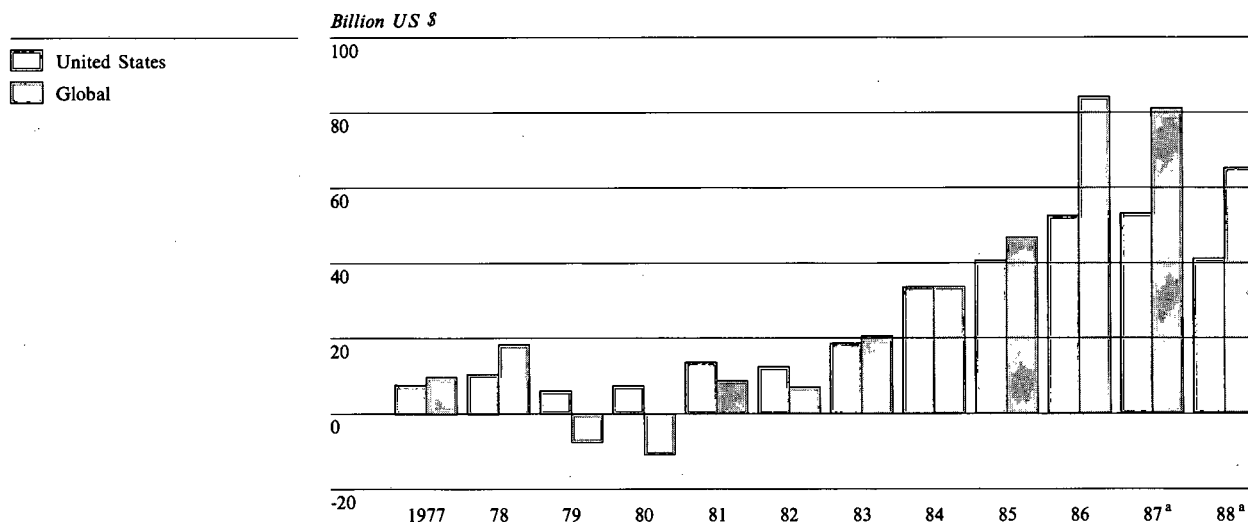
3. Japan's domestic policies also played a role in the burgeoning surplus. We concur with OECD analysis that indicates that a major cause of the surplus was the emergence in Japan in 1978-81 of a large and growing imbalance between domestic saving and domestic investment. This imbalance resulted, in part, from sluggish private investment and Japan's policy of fiscal austerity. The sharp cuts in the central government budget deficit—while improving the government's financial health—reduced the public sector's demand for Japan's savings. This “excess” saving—aided by easing of Japanese controls on financial transactions—flowed out of Japan toward more profitable uses (frequently into securities in the United States and Western Europe, weakening the yen relative to the dollar).

4. Government policies and private practices also discouraged consumer spending and, hence, business investment for the domestic market. During the 1980s, wages rose at an annual rate of only 1 percent, dampening domestic demand and limiting the potential for domestic sales. (Consumer spending accounts for roughly half of GNP as in most other industrialized countries.) Also, nontariff barriers to imports, as well as the intricate distribution system, continued to make it very difficult for foreign firms to break into the Japanese market.

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Figure 1
Japan's Trade Surplus: Global and US



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5. As a result of these factors, exports came to dominate the growth of the Japanese economy more than at any time in the postwar period. Between 1980 and 1985, exports grew by 41 percent in volume terms. Perhaps half of Japan's overall GNP growth and a third of its investment during the first half of the 1980s resulted from exports even though foreign sales were only 15 percent of GNP in 1980.

Yen Appreciation: New Environment for the Private Sector

6. The enormous appreciation of the yen is forcing the private sector to significantly alter its business practices both at home and abroad. Over the last three years, the yen has doubled in value relative to the dollar and has appreciated to a somewhat lesser extent against the currencies of the newly industrialized countries (NICs) in East Asia. Economic rivals, particularly the NICs, are making major inroads into some of Japan's domestic and foreign markets. In addition, restrictions against Japanese imports by many countries have risen somewhat in recent years and are not likely to abate. Pressures from some of Japan's other major trading partners—such as the European Community—will continue.

7. Japanese foreign investment is soaring both in East Asia and in the United States, and we expect it will continue to grow, though somewhat less rapidly. Japan's gross foreign long-term assets will exceed \$1 trillion in the early 1990s. Direct investment, much of which will be in real estate, will reach \$200 billion by 1991. In comparison, US direct foreign investment surpassed \$200 billion only in 1980 after decades of growth. (See figure 2.)

8. Japanese investment in foreign factories will continue to grow rapidly, since combining Japanese technology and know-how with less expensive foreign labor is the key to expansion for several manufacturing industries. The nature of investments will shift from Japan's traditional emphasis on foreign raw materials to manufacturing facilities. Japanese firms will seek to keep those high-skill jobs at home that add the most value to final output. Japan's offshore manufacturing will more than double from 3.5 percent of manufacturing output to about 9 percent by 1990, according to the Industrial Bank of Japan. Even with a slowing of foreign investment growth, which we expect, this figure easily will exceed 10 percent by 1993.

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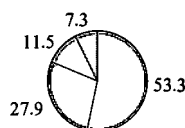
Figure 2
Japan's Growing Financial Clout

Percent

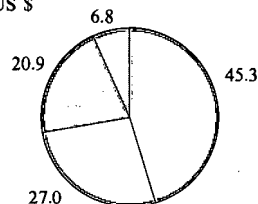
Loans Direct investment Stocks and bonds Other

Gross Long-Term Foreign Assets**1976**

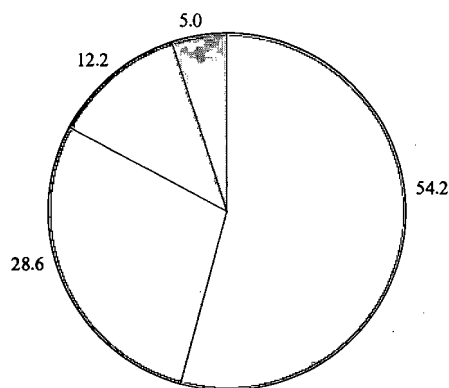
Total=36.9 billion US \$

**1981**

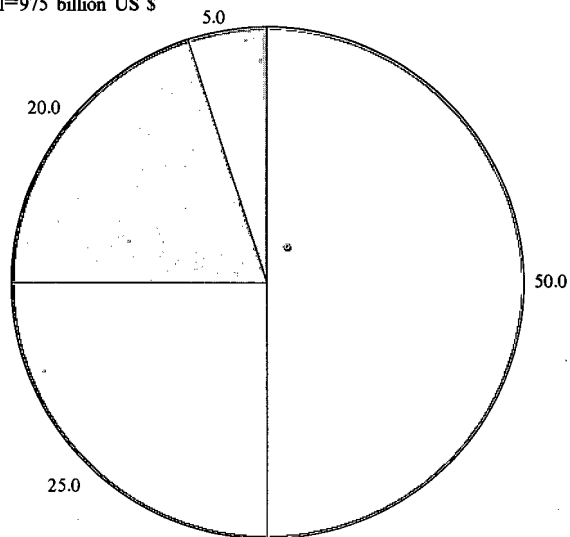
Total=117.1 billion US \$

**1986**

Total=476.1 billion US \$

**1991^a**

Total=975 billion US \$

^a Estimated.

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Government Reaction

9. The Japanese Government has been moving cautiously to accommodate these economic trends and has begun to think about policy changes that will be needed down the line. In the financial area, the decline in investment demand, continuing large savings, and the need to provide corporations with a wider variety of options to both obtain and invest funds prompted a series of changes in financial markets. Over the last six years, the government removed

restrictions for foreign investment, allowed some new financial instruments to be offered, and opened off-shore markets to yen transactions. With the country awash in funds, these moves allowed Japanese funds to receive higher returns than under the old system of close ties between industry and banks. In addition, in part to increase revenues, the government moved to reduce incentives for saving beginning 1 April 1988, when, with certain exceptions, all interest income from formerly tax-free accounts became taxed at 20 percent. This affects the equivalent of \$2.3 trillion of

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individual private savings. To secure opposition party support for these changes, the government linked the savings account legislation to a \$10 billion cut—and partial reform—of personal income taxes enacted during the 1987 fiscal year. More tax change is impending. (See inset, "Japan: Key Financial Market Liberalization, 1984-88.")

10. Former Prime Minister Nakasone tried to stimulate government and popular thinking on Japan's economic future by commissioning a report by the Economic Council's Committee on Economic Restructuring (headed by Haruo Maekawa). The policy recommendations in the "Maekawa" report in part were due to a realization by Japanese policymakers that acceptance of the need to sacrifice as the price for building postwar Japan is gradually eroding. The report took a critical look at Japanese living conditions, for example, and cited a pentup demand for both private and government goods and services. The report's recommendations are confirmed by other studies done by Japanese economist Kenichi Ohmae and by the Tokai Bank that focus on the gap between income and living standards:

- Although Japan's GNP per person exceeds that of the United States at the dollar/yen exchange rate of early 1988, Japanese living standards are considerably lower than those of the United States in most respects.

- A recent study by the Nippon Life Insurance company indicates that almost two-thirds of the 1,000 Japanese polled feel that living standards are low (see inset, "Waiting for the Fruits of Labor").

11. The Maekawa report cited a variety of policy options to promote domestic demand and to reduce reliance on exports:

- Agricultural reform, including reduced subsidies.
- Eased zoning restrictions to slow the rise in Tokyo land costs and to allow for greater private investment and housing construction.
- Better mortgage terms and tax incentives, also to promote housing construction.
- A shorter workweek, improved credit access, and lower tax rates.

All of these recommendations are aimed at stimulating consumer spending and providing new domestic uses for savings. On the financial side, the report targeted continued liberalization of financial markets to stimulate investment and increased foreign aid to productively "recycle" Japan's trade surplus.

Opposition to Change

12. The Maekawa report recommendations encountered opposition from many groups. Despite the per-

Japan: Key Financial Market Liberalization, 1984-88

Measure	Effect
Removed restrictions on Euroyen bonds, syndicated loans, certificates of deposit, and commercial paper markets.	Allowed significant use of the yen as an international currency.
Permitted several foreign banks to join government bond syndicate, introduced auction system for selected bond issues, and introduced six-month and 20-year government bonds.	Increased competition in bond markets and provided foreign firms with new business opportunities.
Deregulated domestic interest rates by periodically reducing the minimum size and maturity restrictions on various financial assets.	Freed about 40 percent of all bank deposits from interest rate controls, provided new funding sources for foreign banks at market-determined interest rates.
Progressively eliminated the tax-free status of most smaller savings deposits, including postal savings system.	Removed this tax incentive to save, and created incentive to shift from postal savings.
Permitted foreign security firms to join Tokyo Stock Exchange.	Created more competition in the stock market and pressure to lower commissions.
Removed most restrictions on access to foreign futures and options markets and allowed creation of domestic futures and options market.	Provided important hedging functions to financial firms. Permitted greater risk management by Japanese and US firms.
Permitted foreign banks to participate in trust banking including the offering of investment advice.	Reduced monopoly advantage of Japanese trust banks in managing pension funds.

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Waiting for the Fruits of Labor

Despite the economic successes that propelled Japan into one of the world's richest countries based on comparisons of output, the standard of living in Japan remains much below that of the United States and much of Western Europe in large part because of very high prices in the protected domestic market. To enjoy the same standard of living as an American couple, for example, a typical Japanese couple would have to spend at least 35 percent more: 50 percent more on utilities and food and twice as much to maintain automobiles.

The lag between increases in per capita income and living standards is best illustrated in the housing sector. More than one-quarter of Japanese homes have no indoor plumbing. A typical Japanese family's cost of housing is one and a half times that of a US family, even though residences are only about half as large on average as those in the United States.

The financial surpluses of recent years, combined with a strengthening of the yen that slowed capital investment, increased land speculation and worked to push up already high housing prices. In 1987, residential property prices in Tokyo climbed an average of 70 percent in yen terms, and by as much as 163 percent in choice locations. As a result, Tokyo real estate prices now are 10 times those of New York City. In one of Tokyo's most expensive residential areas, 1 square foot of property costs \$22,000; a typical apartment in the area—just a plain three-bedroom apartment—costs \$6 million. Middle-class workers earning less than \$30,000 a year pay \$133,000 to \$267,000 for tiny houses that usually lack central heating and are located in suburban areas that entail a two-hour commute from Tokyo.

Japan also has higher food costs than any other industrialized nation; on average the cost of food is about 70 percent more than in the United States. The cost of rice, at retail, is three to five times the US price, while citrus and beef are up to 10 times as expensive—one pound of "ordinary" roast beef costs \$17; one grapefruit costs nearly \$4. In part, these high prices are due to the extensive distribution system through which many food products travel. Japanese consumers pay a series of markups in price to support a wholesale and retail network that employs as high as 20 percent of the Japanese work force. This system is part of a tradeoff whereby consumers pay higher prices to support a societal goal of full employment.

The Chairman of Japan's Socialist Party recently complained in the Diet that domestic prices of imports have not declined, owing to a "government policy of preventing citizens from benefiting from the higher yen." The Prime Minister, however, brushed aside this complaint.

ceived need for change, many opposition politicians, labor unions, and a few prominent members of the ruling Liberal Democratic Party (LDP) who represent influential small business owners are focusing on short-term fixes, lobbying for increased economic stimulus as well as subsidies or tax breaks designed to allow some companies to keep exporting. The Takeshita government, with the support of Finance Ministry bureaucrats and big business, has so far been able to fend off most of these demands.

13. Much of the debate focuses on the necessity for budget stimulus or austerity rather than on reform. Within the LDP and among leaders of big business, there remains a consensus in favor of fiscal austerity, a small public sector, and an export-oriented economy:

- The Keidanren (Japan's most prestigious big business organization) continues to hold that today's deficits eventually will require higher taxes, which will constrain growth.
- Many Japanese believe the country cannot afford to rely largely on its domestic market to generate growth. The proponents of this view argue that institutional and cultural factors such as the excessively high savings rate keep domestic spending well below the level needed to approach full employment and to stimulate sufficient domestic investment. Thus, growing exports represent the only alternative to slow growth and rising unemployment. To fend off criticism from Japan's trading partners, those advocating this position argue that Japan must make available ("recycle") its trade surpluses as increased foreign aid and overseas investment.
- Moreover, many Japanese bureaucrats and politicians argue that Tokyo must slow the growth of the national debt now to prepare for the onslaught of additional expenditure necessary because of the rapid aging of the population beginning in the 1990s. The view that Japan soon will face a critical demographic and economic juncture created by the "graying" of the population was strongly represented in the final report of the Administrative Reform Council—the group largely responsible for selling "budget austerity."
- Lastly, there remains a strongly felt need to ensure against Japan's vulnerabilities as a resource-poor island through thrift and industrial development.

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As to defense, the Japanese remain opposed to significantly increasing spending. Hence, this sector will not pick up any slack. (See inset, "Will Defense Spending Take Up Slack in the Economy?" and figures 3 and 4.)

Tax Reform: A Key Issue

14. From the US perspective, tax reform in Japan is a key long-term issue. Decisions on tax policy—which we expect to be made within the next year or certainly within the time frame of this Estimate—will affect the distribution of consumer goods, land development and housing, and the efficiency of the economy and, hence, Japan's economic future well beyond the mid-term. The government understands that major changes in the system are needed. Currently, the environment in Japan for gradual tax reform is favorable. Prime Minister Takeshita and the LDP support reform. Economic growth is strong. Business profits are adequate. We believe these factors will allow Takeshita to push forward with either a sales tax or a value-added tax (VAT) this year while reducing marginal income tax rates. (See inset, "Tax Reform.")

Will Defense Spending Take Up Slack in the Economy?

Japan's defense budget has not been a significant factor in the overall Japanese economic picture in the postwar period, and we do not expect this to change during the time frame of this Estimate. The Japanese consider defense spending less productive than money invested in the civilian sector. Further, longstanding Japanese policy prevents exports of arms, and constitutional interpretations prohibit anything larger than an exclusively defense-oriented structure. Although defense spending has been increasing since 1980 at an average annual real rate of 4.8 percent, Japan currently spends just over 1 percent of its GNP on defense, about \$29 billion. Comparable numbers for some NATO countries are 6.3 percent for the United States, 4.7 percent for the United Kingdom, and 3.0 percent for West Germany.

Japanese firms that participate in defense production, particularly the high-technology companies, are lobbying strenuously for orders. One group pushed hard for indigenous production of the FSX, Japan's next-generation fighter support aircraft. Although Tokyo decided to codevelop the FSX with the United States, using the F-16 airframe as the model on which to base development, Japanese firms will press for contracts to produce as many of the plane's components as possible. However, the 26 percent of the defense budget that goes for procurement will give only modest support to some of the ailing heavy industries, such as shipbuilding.

Tax Reform

Tax reform will be a major element of the government's strategy for shaping Japan's economic future. In a few years there will be a need for higher revenues, which will be sought from broadening the tax base to prevent an erosion in government revenues that may come with an aging population. Moreover, the tax base will be shifted somewhat to give less favoritism toward small business and farmers.

There is general agreement in Japan that the tax system must be altered. Almost three-fourths of those polled in a recent public opinion survey, for example, believed that tax reform is necessary:

- The tax system is heavily progressive and, with an upper national tax bracket of 70 percent and top local rates at 18 percent, it takes a major chunk of the earnings of those in the top brackets.^a As average incomes have moved upward over the past several decades, resentment toward the tax bite has grown among both middle- and upper-class taxpayers.
- Loopholes in the system have increased dissatisfaction among middle-class families. Whereas self-employed businessmen and farmers can easily avoid taxes because they voluntarily report incomes, salaried workers have no such option because taxes are withheld by their employers.

^a For comparison, all other major European countries have top rates of 60 percent or less. The top rates in the major English-speaking countries are 33 percent for the United States, 40 percent for the United Kingdom, and 34 percent for Canada.

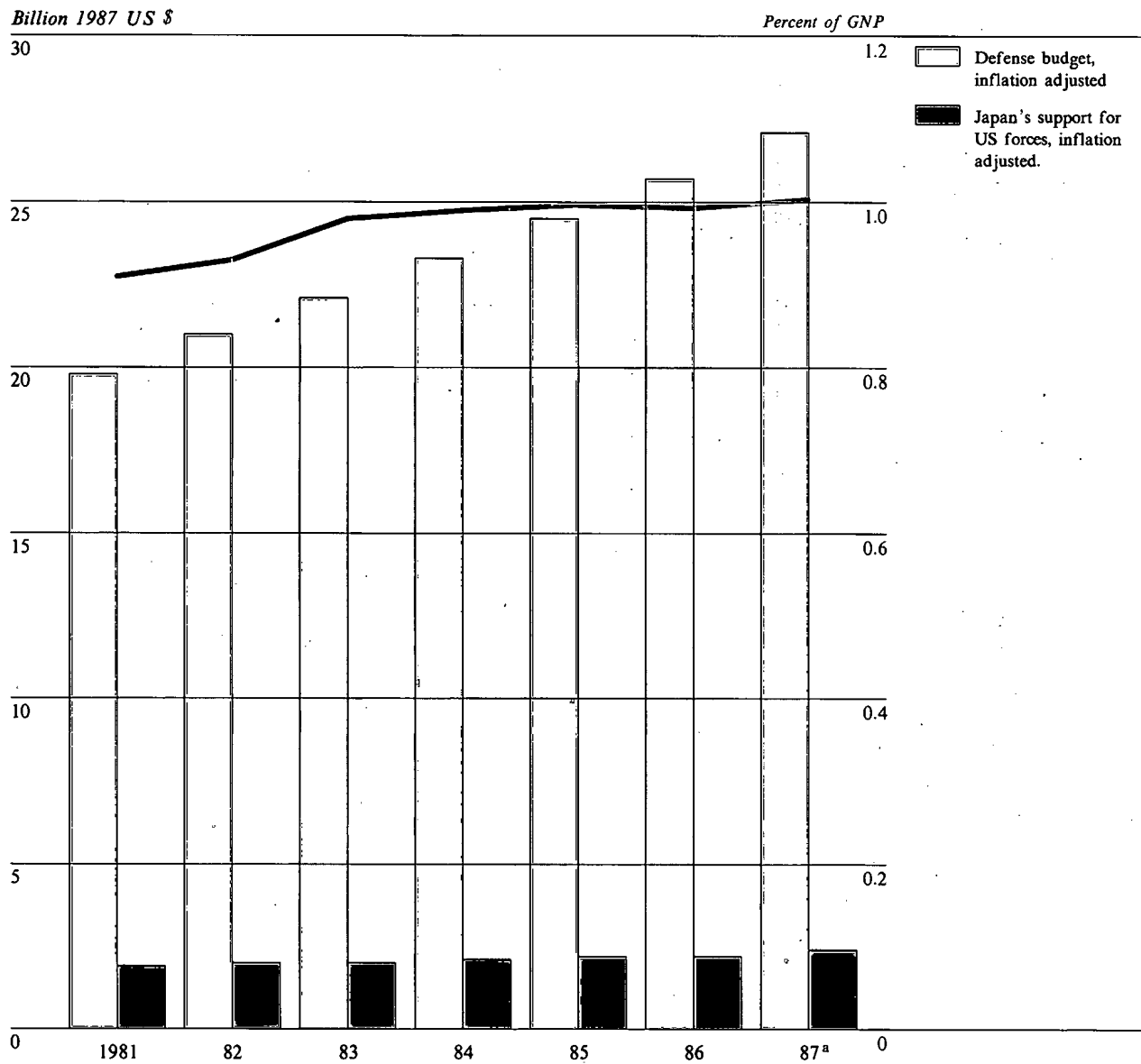
15. The nature of future tax changes can affect foreign interests. Imposition of a VAT to offset projected declines in income tax revenue could help streamline Japan's multilayered distribution system and, hence, be beneficial to US trade interests. The VAT would require recordkeeping and give tax officials access to a chain of vouchers documenting sales at each stage, undercutting the tax evasion that now occurs in the distribution sector. Because most small wholesale and retail firms operate on narrow profit margins, actually paying taxes due could force many out of business, leaving only larger, more efficient distributors. This would increase the transparency of the system. A sales tax, however, which Tokyo also is considering, would not benefit the United States since it would not require such recordkeeping. A Japanese decision on the type of indirect tax to be imposed could be made this year, although passage will have to wait at least until the next extraordinary Diet session beginning in July.

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Figure 3
Japanese Defense Burden, 1981-87

^a Estimated.

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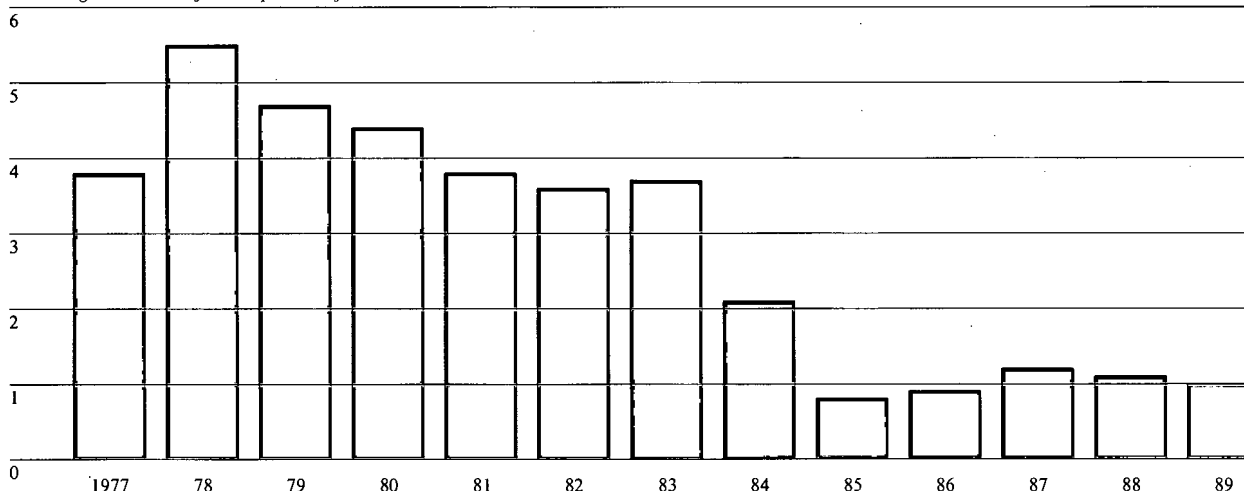
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Figure 4
Japan's Success at Reducing Its Budget Deficit

General government deficit as percent of GDP ^a



^a Excludes social security fund. If it were included for 1987, budget would be in surplus by 1.5 percent of GDP.

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16. Tax, subsidy, and regulatory changes aimed at land reform also are an important element in achieving the US goal of opening markets in Japan and spurring domestic demand. By freeing up agricultural land for development, such reform would stimulate housing demand and, indirectly, create a larger market for other capital and consumer goods. Diverting land near urban areas from agricultural uses would require a significant increase in tax assessments and large cuts in agricultural subsidies that also push up the value of this land. Progress on the land use issue will be slow, in part, because this land is seen as retirement wealth by its owners and also because of the disproportionately large political influence of agricultural interests. (See figure 5.)

Internal Economic Policies for the Midterm

17. We believe the government will continue to make incremental changes in taxes, import policies, and other areas to accommodate the changing economic environment. Changes in the regulatory regime at a measured pace are likely during the period covered by this Estimate. To contend with the longer-term problems induced by the higher yen, the Japa-

nese Government is likely to press the private sector to:

- Put even greater emphasis upon research and development. Japan already spends a larger portion of its GNP on civilian R&D (2.7 percent) than any other country, and it hopes to increase the R&D-to-GNP ratio to 3.5 percent by the mid-1990s.
- Continue the process of factory automation, which will lower costs of production and thereby offset, at least in part, the effects of the higher yen.
- Continue to move away from production of goods toward a knowledge-based "information economy," which has been the government's long-term "vision" for some years.

For its part, the government will implement policies to ease the departure of workers from the declining industries—some of which were successful exporters until recently.

18. The Japanese Government will also take measures to increase consumption as a share of income by gradually reducing the length of the workweek from five and a half days to five days and to 40 hours,

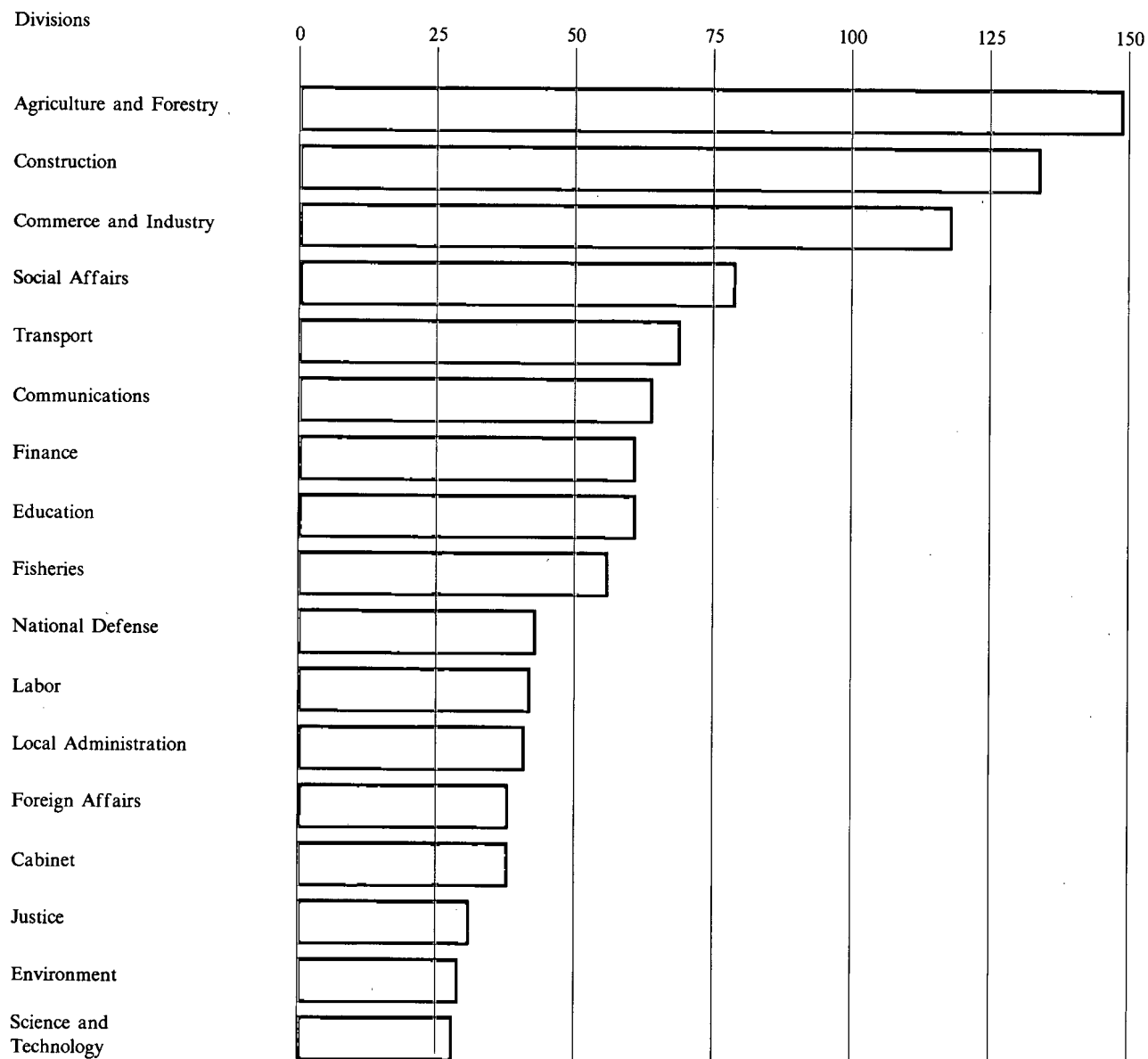
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Figure 5
Interests That Dominate LDP Policymaking

Number of members of LDP Policy Affairs Research Council Divisions



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thereby promoting leisure activities. The government this year hopes to reduce the workweek from 48 hours to 46 hours. Unions are calling for a reduction to 2,000 hours annually—a level that would still require Japanese workers to put in nearly 100 hours more per year than their counterparts in many other major developed countries. Recently, banks, post offices, and the government announced they are switching to a five-day week [redacted]

Downside Risks

19. The pace of economic and related changes in Japan will be conditioned in part by economic events. So far, Japan's economy is performing satisfactorily despite the appreciation of the yen. We believe the government would use some fiscal stimulus to offset a temporary slowdown. A global recession, which would significantly reduce growth in Japan, would pose a risk to the ability of the government to make domestic reforms and to liberalize trade, however. A recession would lead to greater declines in exports, reduce domestic income, and restrain domestic spending, thus limiting the government's room to introduce new policies. [redacted]

20. Further significant appreciation of the yen from the current range of 120 to 130 also would make it more difficult for the government to foster economic restructuring in Japan. The easiest forms of adjustment to yen appreciation have been made, but much more painful actions loom ahead. Exporters that maintained their foreign market share by cutting prices (in yen) and profit margins are nearing the limits of this form of adjustment. Resources are being shifted out of unprofitable export industries, a procedure that is far more disruptive than price adjustment. Marginal exporters who have been drawn into foreign markets by the strong dollar of years past already have pulled back; with further yen appreciation, traditional exporters would have to retreat in the face of foreign competition. We believe that further, gradual yen appreciation would be less of a shock to Japan's economy than would a world recession, but it would be a more lasting drag on Japanese growth. [redacted]

21. A major decline in the yen would hinder the slow restructuring process by taking pressure off the government and the private sector to make changes. Should the yen depreciate significantly, we believe this also would reduce the impetus for change. A depreciation would lessen incentives for firms to invest abroad and would allow for a greater expansion of exports. Yen depreciation could occur for a variety of reasons. One example is significantly higher commodity prices that raise the cost of Japan's imports. [redacted]

Japan's Changing Economy—Implications for the United States

22. Japan's trade surplus will continue to decline as long as Japanese domestic economic growth and the yen remain strong, reducing the overall level of trade friction with the United States but not eliminating bilateral trade friction in a large number of sectors. Japanese manufacturers of high-value-added goods will retain their competitive edge vis-a-vis US firms selling in Japan because of their efforts to adjust to the higher yen, combined with product loyalty from their customers. The domestic market will remain a Japan-first market although foreign products will make new inroads because of enhanced price competitiveness. The NICs, as low-cost producers, and the Europeans, as producers of luxury goods, probably will benefit more than the United States from the boom in consumer spending in Japan. [redacted]

23. Japan will dismantle formal and informal trade barriers only very slowly and only under intense pressure from abroad:

- In agriculture, the most protected Japanese market, the specter of successful GATT suits has quickened internal pressure for agricultural reform.
- Improved revenues from strong growth and tax reform will help finance declining industries.

Intractable problems such as anti-import business practices and nontariff barriers are likely to take the forefront of bilateral disputes. Japanese firms will continue to pursue increased market shares internationally, to form cartels in selected industries such as construction to share the domestic market, and to seek government support for maintenance of informal barriers to imports. [redacted]

24. Competition—both in the United States and Japan—from Japanese products produced in third countries will increase as the Japanese overseas investment boom continues. The involvement of third countries in what was seen as essentially bilateral competition will complicate trade negotiations. Japanese firms increasingly will focus their domestic operations on development of new products, which will be less affected by high yen costs and therefore more competitive with US products. [redacted]

25. The growth of Japanese investment overseas in service firms such as banking and insurance will offer new opportunities for Japanese firms to broaden their international financial operations and compete in an arena dominated by US firms. Japanese financial

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companies are aggressively expanding in world markets. As these firms become more competitive in the full range of financial services in the years ahead, and as attempts are made to insulate Japanese investors from exchange-rate risk, more international lending and borrowing will occur in yen or Special Drawing Rights (SDRs). [REDACTED]

26. Like the United States in the 1920s, Japan does not actively seek to translate its economic power into increased international influence. Nevertheless, concern with the safety of foreign investments and growing ties to countries hosting Japanese investments will force Japan to become more attuned to the foreign policies of others across the spectrum of issues including investment regulations, repatriation of earnings, and security. Hence, Japan will find itself drawn into broader issues related to the political and economic stability of its hosts. Japanese companies abroad will become enmeshed in purely host-country domestic issues, such as taxation, regulation, and general business policy. [REDACTED]

27. There are a few, although sometimes conflicting, signals of this transition. Japan currently is promoting its own candidates and positions in international institutions, even though its positions still generally follow a consensus, rather than shape it:

- Tokyo almost certainly will seek first to fill additional important jobs with Japanese nationals in international forums—for instance, the Asian Development Bank, where Japan traditionally has played a major role.
- We expect the Japanese to become more active in the IMF and the World Bank. They already have strongly supported the enhanced Structural Adjustment Facility and made additional capital infusions to the World Bank that may bring their influence up to the US level. [REDACTED]

28. Japan's growing international economic power offers some opportunities for greater cooperation with the United States:

- As its foreign investment expands, Japan will naturally align itself with the United States' longstanding opposition to barriers to foreign investment.
- As Japan's aid to less developed countries increases, it will push for reforms in their economic policies, although still less forcefully than the United States.
- Japan's foreign aid disbursements exceed those of the United States, but it has far less expertise in allocating aid. Cooperation would be beneficial, in the Philippines, for example, where Japan's aid budget is large (over \$600 million) and growing.

The ascendancy of Japan as an economic power does lessen US leverage on specific trade matters. In particular, as exports to the United States decline as a share of Japan's exports, access to the US market will begin to become a slightly less valuable bargaining chip. [REDACTED]

29. Even though we expect these trends to expand and change Japan's international role, we believe Japan will remain firmly attached to its alliance with the United States and its identification with the West. The Soviet Union would like to propel its modernization program with massive infusions of Japanese technology, but the USSR cannot afford to do so. The Japanese currently see little prospect for substantial growth in exports to the Soviet Union. The same is true for other Bloc countries. The Soviet Union has been pressing for joint ventures with Japan, but it has brought little of economic or political value by Japanese standards to the bargaining table. Should the USSR launch a major political and economic initiative toward Japan, however, including discussions on the Northern Territories, we believe Japan would respond favorably. The Japanese Government may well, for example, encourage private firms to increase economic interchanges with the Soviets. We believe a Soviet initiative is likely within the five-year time frame of this Estimate. [REDACTED]

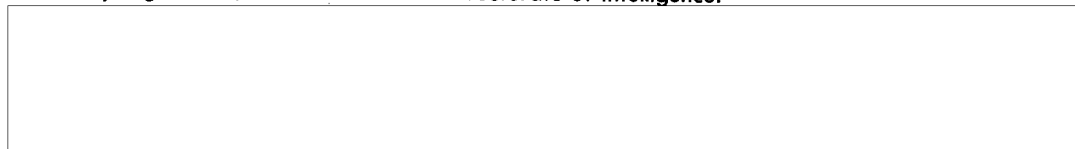
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